

This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 03 MANILA 003370

SIPDIS

SENSITIVE

STATE FOR EAP/PMBS, EAP/EP, EB/IFD, EB/TPP/BTA/ANA
STATE PASS USTR FOR BWEISEL AND DKATZ
STATE PASS USAID AND OPIC
TREASURY FOR OASIA FOR AJEWELL
USDOJ FOR MCRAWFORD
USDOC FOR 4430/ITA/MAC/DBISBEE

E.O. 12958: N/A

TAGS: [ECON](#) [EFIN](#) [EINV](#) [PGOV](#) [RP](#)

SUBJECT: CALMER WEEK ON POLITICAL FRONT PROVIDES RESPITE
FOR FINANCIAL MARKETS

REFS: A) Manila 3279, B) Manila 3326, C) Manila 2878,

D) Manila 2879, E) Manila 2881

11. (SBU) Summary: A relatively calmer week on the political front and positive fiscal news gave currency, stock, and bond markets some breathing space to partially recoup lost gains. The peso traded above the 56 pesos/\$1 level throughout the July 18-22 trading week, but ended the week down slightly from the previous week's close. In the equities market, the stock price index rose to a four-week high and foreign buying more than offset net foreign sales during the first half of July. After rising over the past several weeks, the loan-benchmark 91-day Treasury bill dipped to a 22-month low. However, considering the Philippines' fractious political climate, few discount the possibility of more surprises ahead. Market players will closely watch President Arroyo's July 25 State of the Nation Address and Supreme Court action on the suspended Expanded Value Added Tax law. End Summary.

91-Day Treasury Bill Rates Slide to 22-Month Low

12. (U) Rates for 91- and 182-day papers declined during the GRP's weekly Treasury bill auction on July 18. The benchmark 91-day bills slid to an average rate of 5.452%, down by 72.1 basis points week-on-week. The drop more than made up for successive increases since mid-June 2005 and pulled down the average rate for the 91-day instrument to its lowest level since late-September 2003. Rates for 182-day bills also declined for the first time since mid-June 2005, though by a more modest 10.9 basis points to 7.431%. As of July 18, the average 182-day Treasury bill rate was at a three-week low. The rate had increased by 46.5 basis points from the end of May 2005 (before the audio tapes linking President Arroyo to alleged election fraud surfaced), but was still down by 39.5 basis points from the end of December 2004. Financial system liquidity, lessened political tension, and encouraging first-semester fiscal results that showed the National Government deficit (67.5 billion pesos) well below its programmed 98.5-billion pesos ceiling and about 10% ahead of its financing program also helped ease rates down.

13. (U) Risk premiums continued to rise, however, for the longer-term 364-day bills because of hovering political uncertainties. After rejecting all bids for the 364-day paper in each of its weekly auctions since mid-June as being "unreasonably high," the Government fully awarded its scheduled 2 billion peso offering on July 18. The 364-day paper fetched an average rate of 8.482%, 63.1 basis points higher from when the Government last awarded these papers on June 6. The July 18 average rate for the 364-day bills represented an 11-week high. It was 49.7 basis points higher than at the end of May 2005, but was 140.2 basis points lower than the 364-day rate during 2004's last Treasury bill auction. The average differential between the 91-day and 364-day papers widened to 303 basis points during the Government's July 18 auction, from the 206.5 and 209.4 basis point differentials at the end of May 2005 and December 2004, respectively.

Peso Trades Above 56 pesos/\$1 Throughout the Week

14. (U) Since July 14, the local currency has traded at stronger than 56.00 pesos/\$1 in the inter-bank market. Inter-bank trades ranged from 55.25-55.98 pesos/\$1 during the July 18-22 trading week. The peso opened July 22, the last day of the trading week, at 55.25 pesos/\$1 --

the strongest intra-day rate posted since June 15 -- in reaction to the slight appreciation of the Chinese yuan. However, resurgent political jitters ahead of President Arroyo's July 25 State of the Nation Address capped the peso's recovery and the local currency ended the week at 55.89 pesos/\$1, slightly weaker than the previous Friday's 55.85 pesos/\$1 close. At July 22's closing rate, the peso was down 2.5% (1.37 peso) from the end of May 2005; and was 0.7% (0.39 peso) stronger than at the end of 2004.

Investors Hunting Bargains; Foreigners Net Buyers

15. (U) The Phisix inched up to its highest closing level in nearly four weeks on July 21 (1,960.76) before declining somewhat on profit taking before closing the week at 1,954.40 on July 22. At that level, the Phisix was up 1.3% from the end of May 2005 and up 7.2% from yearend 2004. Foreign investors were net buyers of Philippine stocks during four of the five trading days this week. Net foreign purchases during the week exceeded 1.7 billion pesos, more than offsetting net foreign sales of 1.2 billion pesos during the first half of July.

Sovereign Bond Spreads

16. (U) As of July 21, sovereign bond spreads had narrowed for medium-term Philippine bonds maturing in 2008 and 2010 but had widened somewhat for longer-term foreign debt instruments. Spreads for Philippine bonds maturing in 2008 and 2010 closed 156 and 320 basis points, respectively, above comparable U.S. treasuries, tightening from the previous week's close of 157 and 324 basis points. Spreads for the 2019 and 2025 papers widened to 462 and 507 basis points, respectively, from 454 and 500 basis points the week before. As of July 21, the respective spreads for the 2008, 2010, and 2019 bonds were 47, 19, and 6 basis points narrower than at the end of May 2005, and, for the 2025 bonds, 3 basis points wider. Compared with end-December 2004, spreads for these four bond maturities had tightened by 123, 80, 45, and 13 basis points, respectively.

Comment

17. (SBU) A sense of calm appears to have settled over financial markets this week, but few local observers discount the possibility of more political surprises in the weeks ahead as the opposition works to impeach the President and the Palace tries to establish an independent "Truth Commission" (Ref B). Investors, credit rating agencies, and other observers will also closely watch President Arroyo's State of the Nation Address on July 25 and the Supreme Court's decision on the currently suspended implementation of the amended Expanded Value Added Tax (EVAT) law. The EVAT implementation will be an important test of the Arroyo Administration's political will and its ability to carryout economic reform and stabilize the deficit. As Central Bank Governor Amando Tetangco underscored in recent remarks to the business community, non-implementation of this centerpiece tax measure would deepen fiscal problems and significantly limit the efficacy of monetary policy.

18. (SBU) Despite the media frenzy and oppositionists' claims, and although the country continues to face many important challenges (Refs C, D and E), the Philippines does not appear to be on the brink of economic dysfunction or financial insolvency. The main financial and economic indicators have so far avoided immediate danger. Managers at the Central Bank and the Finance Department deserve at least some credit for maintaining relative economic stability. For now, international reserves appear adequate, the balance of payments is in surplus (nearly \$2 billion as of June), and bankers tell us they see no sign of capital flight. The situation nevertheless remains potentially volatile. Until the EVAT and possible impeachment proceedings are settled, many foreign and domestic investors will be in a wait-and-see mode.

Mussomeli